



# **CLOSING THE LOOPHOLE: Removing Foundation Overhead Costs from Payout**

**A Summary of Editorial Endorsements of Sec. 105 of H.R. 7 and  
NCRP's Analyses of How the Legislation Would Help Charities,  
Preserve Foundations, and Encourage Philanthropic Efficiency**

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National Committee for Responsive Philanthropy**

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**About NCRP:**

**Founded in 1976, the National Committee for Responsive Philanthropy (NCRP) is dedicated to helping the philanthropic community advance the traditional values of social and economic justice for all Americans. Committed to helping funders more effectively serve the most disadvantaged Americans, NCRP is a national watchdog, research and advocacy organization that promotes public accountability and accessibility among foundations, corporate grantmakers, individual donors and workplace giving programs.**

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*The National Committee for Responsive Philanthropy (NCRP) has conducted several analyses and released two reports on the current payout provision currently before the House of Representatives Ways and Means Committee. These reports are available on our homepage at [www.ncrp.org](http://www.ncrp.org). NCRP strongly supports this legislation because it has the potential to increase foundation grantmaking to the nation's financially strapped nonprofit organizations by billions of dollars; will enhance foundation accountability; and reduces and simplifies the rather complex excise tax rules that foundations currently face. Holding current spending levels on overhead costs constant, this provision would increase annual foundation expenses on average by 0.4 percent of their assets. This note provides an overview of this legislation and the key issues that have been debated within the nonprofit sector.*

On Friday, September 5, 2003 the House Ways and Means Committee is scheduled to mark up HR 7, The Charitable Giving Act of 2003, bipartisan legislation that was introduced in the spring by Rep. Roy Blunt (R-MO) and Rep. Harold Ford (D-TN). This legislation is the House's version of the Senate CARE Act, which was passed earlier this year. Originally, the CARE Act was the legislative vehicle the Bush administration was using to advance its faith-based and charitable choice initiatives. However, language pertaining to these initiatives was stripped from the Senate bill and is not included in the House legislation, helping to focus both the Senate and House legislation on incentives to increase charitable giving and foundation grantmaking.

HR 7 contains a provision – **Section 105. Reform of Certain Excise Taxes Related to Private Foundations** – that reduces and simplifies the excise tax private foundations pay on investment income and also effectively creates an all-grants 5 percent payout rate. Currently, private foundations must use at least 5 percent of their assets for charitable purposes, which includes not only grants to nonprofit organizations, but also foundations' own overhead costs. Interpretation of this section of HR 7 indicates that this section will only pertain to private, non-operating foundations. The legislation does not forbid foundations from spending money on overhead. It only no longer allows overhead costs to count as the legal and financial equivalent of a grant to a nonprofit organization.

Many private foundations – especially the nation's most wealthy and well known – have vociferously opposed Section 105, hiring private lobbying firms to have the provision removed from the larger bill, in addition to using the extensive lobbying resources of the Council on Foundations, the foundations' own trade association. The press has reported on foundations pressuring grantees to join their advocacy against the higher grant payouts that would be required by Section 105, and grantees feeling intimidated about speaking out against their funders' positions. Such incidents have not gone unnoticed by members of Congress.

Despite the nearly unlimited resources that the foundation community has mobilized to defeat Section 105, many House members support the provision, which has been endorsed by the editorial boards of major national newspapers, including the *Wall Street Journal* and *USA Today*. The National Committee for Responsive Philanthropy (NCRP) strongly supports this provision of HR 7, and has conducted data analyses on its potential impact on nonprofit organizations and foundations. NCRP has also helped nonprofit organizations lobby in support of the provision. A

growing coalition of private foundations also supports Section 105; coalition members have been lobbying their own representatives to secure their endorsements of the provision.

The purpose of this report is to provide a brief review of the newspaper editorials that support Section 105; the provision's potential impact on the nonprofit sector; and the political dynamics of the debate.

### **Editorial Endorsements**

Below are excerpts from the many press editorials that have endorsed Section 105 of HR 7 or higher foundation payout in general. These are not drawn from opinion/editorial pieces, but are the conclusions of editorial boards at these publications.

- *Forbes* magazine, in the September 15, 2003 edition, endorses the legislation, stating "Congress should pass the bill sponsored by Representatives Roy Blunt (R-Mo.) and Harold Ford (D-Tenn.), which would close this loophole by forbidding foundations to count money spent on salaries, perks, lavish offices and juicy expense accounts as part of the required minimum. Foundations would finally in truth give 1/20th of their boodle every year to charitable causes."
- The *Wall Street Journal's* editorial "Giving a Full 5%" (August 4, 2003) stated that "the Blunt-Ford proposal is a modest attempt to hold foundations to their charitable mandate, and along the way free up billions of more dollars for philanthropic ends. Sounds like a good deed to us."
- The *Milwaukee Journal Sentinel*, in an August 12, 2003 editorial titled, "The Right Helping Hands," concluded that the Blunt-Ford proposal "would add some needed accountability to the rules under which charitable foundations work...Currently, overhead costs can be counted as part of [foundation payout]. The [Blunt-Ford proposal] would close that administrative loophole. That's only reasonable...By approving the [Blunt-Ford proposal], Congress can help to ensure that charitable donations go only to the people who need them."
- The *San Jose Mercury News* (June 2, 2003) editorialized in "How expensive should philanthropy be?" that "The (private foundation) payout rate could be notched higher, by a half-percent or 1 percent, without depleting most foundations' capital...If in doubt, Congress should lean toward requiring that foundations give away more money now..."
- *USA Today*, in a May 27, 2003 editorial titled, "Wealthy charities are most generous to themselves," concluded that Section 105 of the Charitable Giving Act, "together with closer monitoring of foundations, could help curb lavish spending" and concluded, "Unless foundations are willing to focus more attention on funding charitable works than building wealth, they don't deserve the tax breaks they receive in exchange for serving the public good."
- In "Reform begins at home," the *St. Petersburg Times* on July 6, 2003 acknowledged the fears of foundations and concluded, "Good grief...Congress is proposing a modest, and long overdue, change to encourage (private foundations) to meet their charitable obligations...That so many of them are fighting it may speak to its necessity."
- The *Commercial Appeal* of Memphis (July 7, 2003), in an editorial titled, "Keeping social services on track," recounted the difficulties of nonprofits, from service providers to arts

programs, in this economy and concluded in favor of the Charitable Giving Act, concluding “(w)hile the measure may have some effect on their assets, foundations have a more important mission: keeping social service programs on track...The Charitable Giving Act would be a useful tool in achieving that goal.”

- In the Mid-Columbia region of Washington State, the *Tri-City Herald* (May 28, 2003) editorialized in “Charitable foundations need tighter controls” to support the Charitable Giving Act, suggesting that “Congress will do well to tighten up the requirements for foundation money-spending (b)ecause, in a very real sense, much of that money some (private foundations) are hoarding really belongs to the taxpayers.”
- Missouri’s *Springfield News-Leader* editorialized on July 10, 2003 in favor of the Charitable Giving Act, emphasizing that “All (the) provisions (of the Charitable Giving Act) make sense, but particularly the ones demanding that foundations put their tax-exempt status to work for the common good, and not merely to keep a staff well paid”.
- In “Foundations can give more: Boost in required payout could spur smarter spending and investing” (May 20, 2003), the editor of the on-line magazine, *Philanthropy Journal*, charged that “foundation executives are crying wolf.” He observed, “In the face of crushing social ills, and their own hefty salaries, (foundation) executives’ dire warnings ring hollow,” and concluded “Foundations exist to give, not hoard. If forced to give a bit more, they need to be a bit more careful about how they spend and invest.”
- The chief researcher for *onPhilanthropy* wrote on May 31, 2003, “Rather than hand-wringing about how more aggressive spending policies will force foundations to close their doors, foundation leaders ought to stand up and say ‘bring it on.’” She concluded that a spending increase of “(o)ne percent, indeed, less if the reduction in excise taxes is included, is hardly the stuff of Shakespearean tragedy.”

### Issues and Impacts

- **Overhead Expenses Add Up** – Based on NCRP’s analysis of ten years’ worth of IRS data on private, non-operating foundations, \$3.2 billion will be spent on overhead in 2003. This amount would translate into nearly 26,000 average-sized grants to nonprofit organizations if Section 105 of HR 7 were in effect this year. The IRS data also show that nearly half – 44% – of these overhead expenses are devoted to paying for the salaries, wages, and benefits that foundation staff, executives, and trustees receive.

Considering the current economic climate, downturns in giving to nonprofits from nearly all sources, and increases in demands for nonprofit services, now is the time to direct more resources to nonprofit organizations. Socio-economic conditions aside, a foundation grant to a nonprofit organization should not be treated as the legal and accounting equivalent as an executive’s six-figure salary, which is currently the case. Foundations receive their preferential tax treatment for the charitable purpose of distributing money to nonprofit organizations. Foundation laws and regulation should fully reflect this reality, which Section 105 calls for.

- **Payout Rates** – Private non-operating foundations are required to pay out 5 percent of their assets each year. Again, this 5 percent currently includes foundation overhead expenses and

grants to nonprofit organizations. Many foundations pay out exactly 5 percent each year, effectively turning the 5 percent floor into a 5 percent ceiling. IRS data show that smaller foundations tend to exceed the 5 percent minimum much more frequently than larger foundations; smaller foundations also tend to have little – and in some cases, no – overhead costs. Foundations that already exceed the 5 percent payout rate in all grants or have no overhead costs will not be impacted by this legislation.

Interestingly, the foundations with the most overhead costs tend to also have the lowest payout rates, even when taking overhead costs into consideration. For example, the IRS analyzed the payout rates of the 50 largest foundations from 1985-1997, and found that only thirteen actually met or exceeded 5 percent. The other 37 foundations fall short of this legal requirement, sometimes by more than one full percentage point. Looking at the ratio of grants to assets, only four of these top 50 foundations met or exceeded 5 percent in 1997.

- **Returns on Investments** – Many foundation leaders oppose Section 105 of HR 7 because they claim that excluding overhead expenses from payout increases their minimum spending requirement to a level that is not sustainable, effectively drawing down foundation assets to nothing. NCRP's analysis of the legislation's impact on payout finds that on average, Section 105 will increase foundation payout by 0.4 percent of assets – holding current overhead costs constant. For many foundations – which pay out the exact 5 percent minimum required by law – this would result in a 5.4 percent payout rate.

Most research on payout and returns on investments do not, however, substantiate the claims being made by some foundation leaders that Section 105 will bankrupt them. For example:

- Research that the Council on Foundations commissioned shows that foundations could have maintained a 6.5 percent payout rate from 1950 to 1998 and would have still increased their assets by 24 percent.
- A study conducted at Harvard University on the investment returns of 200 of the nation's largest foundations found that they earned an average return of 7.62 percent, while paying out an average of only 4.97 percent.
- A new analysis that a US Bancorp/Piper Jaffrey investment banker presented at a recent meeting of Northern California Grantmakers found that an investment portfolio made up of 70 percent equity stocks and 30 percent government bonds earned nearly an inflation-adjusted 8 percent return from January 1980 through December 2002.
- Lincoln Investment Planning, Inc. reports that the S&P 500 earned an average annual return of 10.2 percent from 1926 through December 2002. Investments in small stock companies yielded an average return of 12.2 percent for the same period.

Further, IRS data show that many foundations annually receive new infusions of money beyond returns on investments, including new contributions from individuals and profits from real estate holdings. Assuming that the only source of revenue for foundations is returns on investments simply does not reflect the reality of the philanthropic sector. And considering that the foundation sector has more than quadrupled in size over the past 25 to 30 years, it is mathematically impossible that the small increase in expenses that would take place under Section 105 will drain foundation assets and bankrupt the sector.

- **Grassroots and Public Policy Advocacy Organizations** – Although foundation grantmaking makes up less than 10 percent of total nonprofit revenue, foundation money is a key source of income for grassroots advocacy organizations. For example, a recent NCRP report on grassroots public policy advocacy organizations in the Washington, DC metro area found that 47 percent of their budgets came from foundations. These organizations represent diverse constituencies, work on controversial issues, and provide few services. Consequently, they are highly dependent on foundation funding, since individuals and the government are unlikely to fund them. A similar study of neighborhood and community organizing groups in New York City, conducted by the National Center for Schools and Communities at Fordham University in 2001, showed most of the more than 70 organizations studied were highly if not totally dependent on foundation support, with 63 percent of their total revenues coming from foundations. NCRP's own 2000 research of advocacy organizations in California showed that 25 percent of the budgets of progressive public policy nonprofits came from foundations.

Unfortunately, organizations like these receive a minute proportion of total foundation grantmaking: in 2001, only 1.1 percent of all foundation grant dollars were awarded to such groups. As our nation deals with a sluggish economy, high levels of unemployment, and government-led challenges to civil liberties, now is the time that grassroots advocacy organizations need more funding to adequately represent their constituents. Passing Section 105 of HR 7 into law is one means to help achieve this goal: as foundations increase their grantmaking to meet the 5 percent all-grants minimum, all types of nonprofit organizations have the potential to benefit by receiving these charitable dollars.

- **Small Organizations** – Many foundation officials who oppose Section 105 claim that the provision will force them to cut their staffs and start making large grants to large institutions, implying that their program staffs currently spend much of their time finding, funding, and working with smaller organizations. But considering that nearly half of all grant money awarded is for grants larger than \$1 million and that 35 percent of all grant dollars are devoted to educational institutions, museums, and hospitals, it's hard to say that Section 105 would cause foundations to start making large grants to large institutions – they already do it, due to the fundamentally inequitable nature of private philanthropy. Further, Section 105 does not prohibit foundations from spending money on their overhead costs – it merely no longer allows such costs to be counted as the financial and legal equivalent of a grant to a nonprofit organization. And since Section 105 will not significantly increase foundation expenses, there is no financial reason why foundations could not maintain current overhead spending levels to manage their grantees.
- **Trustee Fees** – A recent study by Georgetown University's Pablo Eisenberg (one of the founding members of NCRP and a current board member) and his colleagues found that a large majority of the nation's largest foundations (and a large majority of selected small foundations) financially compensated their board trustees. The 238 foundations in the study's sample paid their trustees nearly \$45 million in 1998 (such payments are an allowable "charitable" expense under current law and can therefore be included in payout).

Clearly the level of trustee fees paid by many foundations is hard to fathom as a defensible charitable expenditure. Like many other aspects of the non-grant expenditures of foundations, the only constraint is whether or not the expenditures are “reasonable” – and there is no clear standard for determining what might be reasonable trustee fees or reasonable levels for any other aspect of foundations’ overhead expenses. Without their exclusion from foundations’ qualifying distributions, there is little incentive – except the common sense of foundation executives – to rein in overhead expenses that can be counted toward foundation payout. In very simple and direct terms, Section 105 eliminates the incentive for unconstrained private foundation spending on overhead expenses.

### **Political Dynamics**

- **Economics, Not Politics** – As mentioned earlier, Section 105 has proven to be a rather contentious provision in HR 7. For the most part, this issue has not been divided by party lines. Some conservative foundations, organizations, and lawmakers support it, while other conservative entities oppose it. Similarly, some organizations and individuals on the left support Section 105, while others oppose it.

In past debates over foundation payout, NCRP has been categorized as radically to the left, trying to promote higher payout for the purposes of social change and social justice grantmaking. When we initially supported Section 105, we were categorized as being part of the right-wing political agenda, helping conservative lawmakers to drain the assets of progressive foundations. But for us, payout has always been about economics and not politics. While we would certainly like to see progressive organizations receive more funding from all potential sources, we simply believe that data show that foundations can afford to give more than they currently do. And our experiences working with nonprofit organizations tells us that they need more funding – especially those that work to serve and represent disadvantaged communities and constituencies.

### **Conclusion and NCRP Policy Recommendation**

Considering the dire financial straits that nonprofit organizations are facing, the many unmet needs in our country, and the hundreds of billions of dollars that foundations have in assets, we recommend that the House Ways and Means Committee, and then the full House of Representatives, and then the Senate, keep Section 105 of HR 7 intact and completely eliminate the foundation sector’s ability to count overhead costs in their annual payout rates. This change in policy will not be a huge burden for foundations – by most indicators, it will allow them to continue to receive a positive return on investments of their financial corpus. It will also bring some consistency and transparency to foundation grantmaking practices. Support for Section 105 of HR 7 means under girding this nation’s struggling nonprofit sector, and the millions of people who depend on it for essential services and representation.